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FOR RELEASE TO A. M. PAPERS
TUESDAY, MARCH 9, 1965

THE 'EVOLUTION' IN BANKING REGULATIONS AND REPORTING

An Address by

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Washington, D. C.

before the

Los Angeles Chapter
ROBERT MORRIS ASSOCIATES

Los Angeles Chapter
CALIFORNIA SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

and

LOS ANGELES BANK CREDIT MEN'S ASSOCIATION

at their

Annual Joint Dinner Meeting

Statler Hilton Hotel
Los Angeles, California

Monday, March 8, 1965
8:00 P. M.

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THE 'EVOLUTION' IN BANKING REGULATIONS AND REPORTING

Some time has passed since legislation was enacted requiring more complete disclosure by banks, and since the Federal Deposit Insurance Corporation and its sister Federal banking agencies issued implementing regulations. The initial industry reactions are over; the first proposed rules have been considered, revised and adopted. The time has come, finally, to go beyond discussion of what is in the law and to ask why it was necessary and, above all, what it can do for the industry and for the industry's customers -- the general public.

This was no hastily developed legislation. The law, and the rules promulgated thereunder, were worked out over a period of time, carefully and deliberately. The mandate expressed by the Congress in passing this legislation was weighed for some time before passage. The agency debates, before the regulations were issued, were quite exhaustive -- and many bankers played a part in those debates, as you no doubt know.

Congress asked the banking industry, and its supervisors, to go somewhat beyond the classic, and still vital, depositor orientation to give greater protection to the shareholder of, and potential investor in, a bank's stock. In the final analysis, however, Congress asked the industry to protect not only the investor but the depositor, and, in a large sense, the industry itself, through a greater willingness to subject its activities to open scrutiny.

It is my feeling that the regulations which have resulted from this Congressional mandate offer some excellent potentials for the banking industry. If the industry develops the right approach to these new rules,

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if the industry looks at these rules not as a burden but as an asset which can be used constructively, I suspect that in at least three ways they can be of great help.

Most obviously they can be of great assistance in attracting new capital, and this is a period of time when capital is available and can beneficially be acquired for future economic expansion and consequent demands for bank loans.

Secondly, these rules can offer a positive tool for high level bank salesmanship, selling services to corporations and other sophisticated customers. These are the kind of depositors who want to know as much as possible about the people and firms they deal with, and the new disclosure rules offer a large potential in this area.

Finally, and in my view as important as either of the foregoing, these rules can, if properly applied, serve to enhance the public's confidence in banking as a whole and more especially in the banks subject to the disclosure regulations. Much the same effect already has been experienced by those industries subject to the disclosure rules of the Securities and Exchange Commission for the past 30 years; the same advantages should accrue to banking.

To place this in perspective, it will help to analyse the regulations, their genesis, and the manner in which the banking agencies have tailored them to the banking industry as it is today. The rules have been carefully shaped to serve present banking needs. At the same time the rules are flexible and changes are possible as experience with them develops.

To begin with, the banking industry traditionally has been depositor oriented, a posture fostered by the supervisory agencies. The industry,

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and its supervisors, always have been conscious of the fact that 92 percent of the bank balance sheet, on the right hand side, consists of deposits, while only 8 percent comes from capital. This banking structure means, essentially, that bankers are operating with a form of "capital" -- deposits -- which are not risked by the bank's owners in the normal manner, but which have been entrusted to the bank in a fiduciary capacity.

Congress, however, after extensive debate, determined that some of the protections afforded shareholders in more conventionally capitalized industries should be afforded to bank shareholders. Congress determined to extend disclosure rules to corporations whose shares are traded in the over-the-counter markets, including banks, despite the classic orientation of banks toward depositors.

Congress carefully considered the banking industry's unique structure, and determined finally that although disclosure rules would be extended to banking, the administration would not be vested in the SEC, but in the bank regulatory agencies themselves.

In my view this was an excellent decision, because it permits a blending of the depositor protection, still so vital, and the new protection to shareholders by the regulators who understand the historic responsibility to depositors and who understand the banking industry's unusual capital structure.

On August 20 the Securities Acts Amendments of 1964 became law, and shortly thereafter the Federal Deposit Insurance Corporation and the Federal Reserve Board issued rules and regulations for comment, based substantially upon existing Securities and Exchange Commission rules. The Comptroller of the Currency had skeletal regulations out for comment at

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that time, which became immediately effective and which are still in effect. The Comptroller, I am sure, grappled with many of the considerations which faced FDIC and the Fed, concerning the unique capital structure of the banking industry. He opposed the legislation in the Congress, and when the Act was passed despite his opposition, apparently felt that the SEC approach would not serve the national banking system under his supervision.

The other two Federal agencies took a different tack. They issued the regulations largely patterned upon those of the SEC for comment, in the belief that this was as good a starting place as any. The SEC rules had been in existence for over 30 years. They had been tested in action, and revised over the years to sharpen and improve their effectiveness. The banking agencies had no experience in this field, while the SEC had a massive body of experience. We felt it would be most appropriate to take a look at how the SEC rules, adjusted for banking, might work out.

We asked for comment, and we got it. Bankers and bank groups all over the country expressed their views vigorously and in detail. Working closely with banker groups, and with the Federal Reserve System, we fashioned a new set of regulations. These were carefully tested with three main goals in mind: to fill the mandate of Congress to protect and inform shareholders and investors, to lessen any adverse effects on banking and prepare for gradual development of some aspects of the regulations, and to prepare rules which would develop even further the effectiveness of the banking industry as a servant of the public while adding to the public's confidence in that system.

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Following this careful study, new regulations were issued on December 31, to become effective the next day. We chose not to issue these new regulations for comment, to become effective at a later date, but to issue them as "living" regulations, effective immediately and subject to revision as the need might arise.

In part this action was taken to meet the timetable imposed by Congress. Additionally, we felt that the industry had given us a massive amount of information and we had considered all of this carefully in preparing the new set of regulations. What is now needed, in this viewpoint, in some concrete experience with the rules. We have gone beyond the period where philosophy, intuition, and the experience of other agencies is very helpful. What is needed now is a period of time within which banks themselves may test the rules by living with them. As needed revisions are suggested by this process, they will be considered, and, where necessary, made.

What we have sought to do with the regulations can be shown by comparing some of the differences between the first and second set of regulations issued by the Federal Deposit Insurance Corporation, the differences which finally have come about between the Federal Deposit Insurance Corporation regulations and the SEC approach for more capital oriented industries, and, to a degree, the differences between the Federal Deposit Insurance Corporation regulations and those governing national banks. All of this leads to an analysis of what the regulations do, but better perspective is available if we first consider the points raised above.

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Among the differences between the first proposed regulations and the final effective regulations was the elimination of the requirement of outside certification of financial statements by independent public accountants. Now, under the current regulations, a bank may choose whether to have the statements certified by an outside accountant or verified by the bank's principal accounting officers.

FDIC did reserve the right to require outside certification in any case where FDIC informs the bank that it is necessary at least 90 days prior to the close of the bank's fiscal year.

Another difference relates to the definition of securities "held of record," which determines whether a bank has 750 or more equity security holders of one class and therefore is subject to the registration, reporting, and other requirements of the Securities Exchange Act of 1934 and our regulations. In the new regulations the stockholders of banks' parent corporations (including bank holding companies) have been excluded in the computation.

A third modification in the effective regulations covers the extent to which banks, in soliciting stockholders' proxies, must disclose transactions between the bank and enterprises in which the bank's directors, officers, or principal stockholders are interested. The regulation now exempts from disclosure requirements indebtedness of officers, directors and 10 percent stockholders arising in the ordinary course of business.

The differences between FDIC regulations and the regulations imposed by the Securities and Exchange Commission on registered companies, are, I think, of great interest, and of major significance in showing how we

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have treated the essentially unique banking structure while attempting to meet the requirements of the Congress.

The primary area of difference embraces the question of certification of financial statements. While SEC requires that most registration statements and annual reports filed with it must be accompanied by such certified financial statements, the FDIC rules do not. The reason for this departure lies largely in the unique nature of banking. For many years banks have maintained their books and records and reported their financial affairs in a manner not strictly in accord with generally accepted accounting principles as that term is used by the American Institute of Certified Public Accountants. Moreover, official FDIC policy, expressed both in written form and verbally through examiners, has encouraged and re-inforced such special bank bookkeeping and reporting techniques. Both the supervisory agencies and the banks have reflected in these practices their depositor orientation, and little concern had been focused upon stockholder or investor protection.

Now, however, the Congress has told the industry and the supervisory agencies to look to stockholder and investor protection. The FDIC regulations do, in many specific instances, require alterations of bank accounting practices to bring them more nearly in line with generally accepted accounting principles. However, the gap is too wide to make the sudden leap -- that all banks engage independent auditors and fully subject themselves to those accounting principles.

Another important area of difference is in the proxy solicitation rules. Over the 30 years that the SEC has administered proxy rules for corporations whose securities are listed for trading, certain safeguards

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designed to preserve and encourage "corporate democracy" have been crystallized into regulation. One of the provisions is the requirement that management include within its own proxy statement a 100 word, or less, statement by any stockholder of record which statement is designed to secure the passage of a resolution by the stockholders at the forthcoming stockholders' meeting. This provision has been omitted from the FDIC rules.

This provision should not be confused with the SEC rules, retained by FDIC in its regulations, that management must mail on behalf of a stockholder, his proxy statement upon receipt of sufficient money to defray the cost, or as an alternative make available to the stockholder the stockholders' list. FDIC has not required the further step of including a stockholders' statement within the management proxy, although it is still under study. The SEC rule which FDIC dropped has not, in the minds of many students of corporate practice, been one which usefully serves the needs of minority stockholders. In fact, it has at times become a provision which has been abused by certain stockholders who desire publicity or who have used it as a means of harrassing management without true regard for the benefit of the corporation in question.

One further variation from SEC rules worthy of note occurs in one of the forms required for registration, where the unique structure of banking has caused a modification. SEC's equivalent form requires the registrant to state, in the terms of the percentage of business done, the principal lines of endeavor. The FDIC rules make no such requirement. FDIC asks that banks briefly describe the business done, the significant developments or business transactions occurring over the preceding five

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years, and any significant acquisitions, or mergers, which may have occurred recently.

As suggested earlier, the Comptroller of the Currency issued skeletal regulations covering national banks. They vary so greatly from those issued by the FDIC and the Fed that no brief comparison would be helpful. No doubt he was impelled by a preoccupation with depositor protection and with the latitude to formulate rules allowed the supervisory agencies by Section 12(i) of the Act.

Having touched upon the differences between the first and final regulations of FDIC, and between those final regulations and those of the SEC and of the Comptroller, we can now examine the regulations themselves. There are five major elements covered by these regulations. In summary, they are:

1. A registration statement is to be filed within 120 days after the ending of its fiscal year by each bank covered under the regulations. Banks concerned must have at least $1 million in assets and at least 750 shareholders of a single class of stock.

This statement will contain pertinent information about the bank, including a description of its business, a list of principal security holders, holding 10 percent or more of the issue, a list of directors and officers, remuneration of the two principal officers and certain directors, the interests of management and principal stockholders in certain transactions with the bank, stock purchase options, high points of the banks' principal financial changes over a ten-year period, a consolidated balance sheet for the most recent year-end, and a statement of income and expenses, along with changes in the bank's capital accounts for 1964 and the two preceding years.

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2. Periodic financial reports for the bank must be filed including an annual report updating much of the information contained in the registration statement, including balance sheet, earnings statement, and reconciliation of capital and reserve items for the year. In addition, quarterly reports on major elements of net operating earnings must be filed.

3. Current reports must be rendered about major events as they happen. Included are such matters as change in control of the bank, material legal proceedings to which the bank has become a party, changes in the outstanding securities of the bank, any new stock purchase options granted by the bank, and any revaluation of the bank's assets, or other major changes in asset structure.

4. Rules must be followed for solicitation of proxies from stockholders, by management and others, for special or annual meetings. These generally follow SEC rules, with the exceptions noted earlier. Provision is made for furnishing information prior to annual meetings even though proxies are not solicited.

5. Reports are required on securities transactions by "insiders." Directors, major officers, and persons owning 10 percent or more of a bank's stock are required to file initial statements of their ownership, and statements on subsequent transactions as they occur.

So much for the regulations, how they were evolved, and how they differ from other major rules in the same general area. Earlier I briefly touched on the idea that they can be of positive advantage to banks covered by them. There are, I strongly believe, three main areas in which bankers, given the desire and the proper use of these regulations, can translate them into a positive asset, instead of a new set of rules causing only costs and

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paperwork. The costs are there; the paperwork is there; but that can be recouped many times over if bankers will view these rules not as enemies to be lived with because they cannot be disregarded, but as tools for positive action.

The first of these advantages lies in the capital needs of every growing bank these days. It is a nice position to be in if a banker can keep his capital up through retained earnings only, but two factors at least mitigate against this approach.

One is the fact that loan demand for the past few years has far outstripped both deposit and capital growth. The banking system was so liquid, after the end of World War II, that this was not then a problem. But the continued pressure of a return to a more normal economy, the continued prosperity which permeates all walks of life, has all but eliminated any capital cushion. Secondly, banks in recent years have faced a cost-earnings squeeze, during which the cost of banking raw materials -- deposit dollars -- has gone up, along with other expenses, while loan rates have held relatively stable. The result has been that while earnings have gone up, net earnings per hundred dollars of gross earnings have dropped considerably. Earnings as a source of retained capital are not playing nearly the part they did during the 1950's.

As a result, the banking industry in recent years has turned to the capital markets, trying new tools, such as debentures, convertible debentures, preferred capital, and even notes. There is no reason to think that banking capital needs will not increase in future years, as the economy continues to grow. Indeed, banking support through its loan and investment portfolios is one of the primary reasons for that growth, and

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there is no reason to think banks will not want to continue their activities. But all this will require capital. And what bank will be better able to persuade competent and intelligent investors to buy bank issues than that bank which makes a full disclosure of its operations to investors?

Secondly, banks have found in recent years that corporate treasurers, union pension fund officials, foundation and charitable fund operators, and other sophisticated officials handling hundreds of millions of dollars have become more and more selective in the investment of their funds and the selection of their banks. They want to look a bank over carefully before they place their heavy commitments in the institution. The small depositor has FDIC as his guarantor, up to $10,000 for each depositor, but the large depositor cannot turn to FDIC nor should he want to. He should still insist that the bank's management, its ability, and its record, are the primary considerations. Again, the most logical places to turn will be to those banks most willing and able to disclose full information about their operations.

Finally, the public's confidence, gradually restored after the Depression, as the banking industry has been buttressed by the FDIC and by many sound years of operation, will be enhanced by any policy of fuller disclosures. This was one of the key points in the recovery of the stock market and the renewed willingness of investors to invest in American industry. The operations of the Securities and Exchange Commission, in supervising such companies and in fostering the fuller development of information for the public, gradually restored confidence in and a willingness to invest in industry.

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This confidence is crucial for the banking industry. This nation has known all too many panics which pulled down otherwise perfectly sound banks because the public lost confidence and pulled funds out of the banks, causing liquidity crises. While this has not happened in the past 30-odd years, and while we all like to think it can never happen again, the surest safeguard is to maintain public confidence, and the surest way to maintain that confidence is to merit it.

The task begun with the Securities Act Amendments of 1964 and the implementing regulations of FDIC, the Federal Reserve, and the Comptroller of the Currency, is not finished, in my view. These new regulations do require more uniform accounting procedures, and that is all to the good.

The requirement that accrual accounting be used wherever practical, the requirement that securities accounts are to reflect amortization of premiums and accretion of discounts under certain options, requirements that market value, as well as book value, be disclosed for holdings of common stocks, and non-investment grade bonds, the separation of gains or losses in bond trading activities from interest income -- all these are positive strengths in the regulations, in my view. But I am sure that as we gain experience with these regulations, the banking industry will develop even further refinements leading to a more uniform and a more consistent accounting procedure for the industry.

Additionally, while we have not required outside certification, for reasons outlined earlier, this continues to be an ultimate possibility. After all, industry finds that despite heavy internal audit programs, outside audits and outside certification pay dividends. After all, bankers

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themselves generally require certified statements from borrowers. Theoretically, if uniform audit procedures were followed the Federal banking agencies could act as the outside certifying agencies, but this would entail a great strain on these agencies and increase the costs of their operations, a cost borne, as you all know, by the banks themselves.

This question of outside independent audits and certification may become a moot point. Rep. Wright Patman of Texas, chairman of the House Banking and Currency Committee, has introduced a bill which would require an outside independent audit for every insured bank once every three years, and there are Washington observers who feel that the measure has a chance of passage.

Perhaps as these new regulations of the Corporation, and of the Federal Reserve, prove their worth -- and I am sure they will -- other banks not covered by them, including possibly the larger national banks, will find themselves at a disadvantage in going to the capital markets, or in securing the larger, more sophisticated customer, and will want to come under the cover of the regulations. This, I firmly believe, would be a healthy development, one of benefit to the public, and to the industry. These regulations were not developed to place a new burden on the banking system, but to give greater protection to the bank investor, and, ultimately, to the bank itself and the public at large. Properly utilized, these regulations can serve not only as protection for the public and the investor, but as a new, positive, and important tool for the intelligent, forward-looking bank management.

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